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(R76-213)

BRUCE E. BABBITT
ATTORNEY GENERAL

76-190

June 23, 1976

Mr. Robert L. Merrill
Administrator
Arizona Department of Revenue
State Capitol
1700 West Washington
Phoenix, Arizona 85007

Dear Mr. Merrill:

In your letter of April 30, 1976, you asked whether sufficient taxable nexus existed for taxing certain out-of-state companies engaged in conducting boating tours down the Colorado River through the Grand Canyon.

A state may constitutionally levy a net income tax upon a business engaged in interstate commerce. Northwestern States Portland Cement Company v. State of Minnesota, 358 U.S. 450, 79 S.Ct. 357 (1959). The Supreme Court held in that case that the net income from the interstate operations of a foreign corporation may be subjected to state taxation--provided the levy is not discriminatory and is properly apportioned to local activities within the taxing state forming sufficient nexus to support the tax. Therefore, the fact that some or all of the companies in question may be engaged in interstate commerce will not prohibit the State of Arizona from levying a net income tax on such companies. The determining factor is whether a sufficient nexus exists so that this State may legally tax the companies in question. It is not necessary, in this opinion, to pass on the question whether these companies are engaged in interstate commerce, for a sufficient nexus does exist.

Whether sufficient nexus exists is determined by the extent of the business activities performed in this state by the companies involved. Congress, by P.L. 86-272 (15 U.S.C. § 381, *et seq.*), has set forth the minimum requirement before a state may impose a net income tax on a foreign corporation engaged in selling tangible personal property. P.L. 86-272 states in part:

"a) No state, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, a net income tax on the income derived within such state by any person from interstate commerce if the only business activities within such state by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1)."

While P.L. 86-272 appears to apply only to companies engaged in selling tangible personal property, it does indicate Congress' position on what constitutes minimum taxable nexus. It is evident that even under the guidelines set forth in P.L. 86-272, there is sufficient nexus to tax the companies conducting the Colorado River trips. Pursuant to the information that you provided, it appears that all of the Colorado River trips begin at Lee's Ferry, approximately 12 miles inside the Arizona border, and generally end within the State of Arizona. Once the season begins, the rafts and the employees conducting the trips are based in Arizona. Most of the preparation for the trips also takes place within Arizona. Finally, the trips themselves--the revenue producing activities--take place wholly in Arizona. From this information, it is evident that sufficient nexus exists so that Arizona may levy a net income tax.

Furthermore, the fact that most or all of the activities take place on federally regulated land does not immunize these companies from state taxation. While it is generally true that a state may not impose taxes within a federal enclave without the permission of the Federal Government, it appears that in this case, permission has been granted. 4 U.S.C. § 106(a) states in part:

> "No person shall be relieved from liability for any income tax levied by any State . . . having jurisdiction to levy such a tax, by reason of . . . receiving income from transactions occurring or services performed in such area; and such State . . . shall have full jurisdiction and power to levy and collect such tax in any Federal area within such State to the same extent and with the same effect as though such area was not a Federal area."

A "Federal area" is defined by 4 U.S.C. § 110(e) as:

> ". . . any lands or premises held or acquired by or for the use of the United States or any department, establishment, or agency of the United States; and any Federal area, or any part thereof, which is located within the exterior boundaries of any State, shall be deemed to be a Federal area located within such State."

With this broad definition of Federal area, it is evident that National Parks and National Recreation Areas are Federal areas, and the companies are liable for Arizona Income Tax upon income generated by their "river-running" services.

Lastly, the fact that the Colorado River is a navigable stream does not deprive the State of its taxing powers. Even though most of the activities take place on navigable waters, a state still has the power to levy an income tax so long as it is fairly apportioned to income from activities occurring within the boundaries of the State. Smith v. State, 391 P.2d 718 (Wash. 1964). A state may, for example, legally tax a corporation engaged in the business of towing vessels on the Hudson River, which are navigable waters of the United States. New York ex rel. Cornell Steamboat Co. v. Sohmer, 235 U.S. 549, 35 S.Ct. 162 (1914). It is therefore irrelevant that the Colorado River is a navigable stream.

You also asked whether the separate or the apportionment method of accounting would be more appropriate if these companies were found to be taxable. A.R.S. § 43-135(g) states in part:

> "When the income of a corporation subject to the tax imposed under this title is derived from or attributable to sources both within and without this state, the tax shall be measured by the net income derived from or attributable to sources within this state . . . . The

> income attributable to sources within this state shall then be determined by (1) separate accounting thereof when requested by the taxpayer or required by the department to more clearly reflect the income of the taxpayer, or, (2) an apportionment upon the basis of sales, purchases, expenses of manufacture, payroll, value and situs of tangible property including leased property or by reference to any of these or other factors or by such other method of apportionment as is fairly calculated to determine the net income derived from or attributable to sources within this state . . . ."

Subsection (g), in allocating income, gives the Department the choice of using either separate accounting, or an apportionment formula. The statute does not favor one method over the other. The statute does direct that the Department should use that method which more clearly reflects the income of the taxpayer that is derived from or attributable to sources within this State. The determination as to which method more clearly reflects the income of each taxpayer derived from or attributable to sources within this State will have to be made by the Department after sufficient investigation.

While there are no appellate court decisions on this question in Arizona, courts in other states have considered which method should be used in dealing with construction projects. The courts have been divided on whether separate accounting or an apportionment formula should be used. In general, the courts that favor the use of an apportionment formula in determining the income of a construction company were in states that had enacted the Uniform Division of Income for Tax Purposes Act. The courts in those cases generally held that under the Uniform Act, the apportionment method is now the general rule, and any other system, including the segregation or the separate accounting method, is the exception. Two cases from Oregon involving construction companies illustrate this point. Utah Construction and Mining Co. v. State Tax Commission, 465 P.2d 712 (1970) involved tax years that were prior to Oregon's adoption of the Uniform Act. The previous statute gave the Tax Commission authority to permit or require the segregated or apportionment method of accounting as long as either method would fairly and accurately reflect the net income of the business done within the State. The Court stated at 465 P.2d 713:

> "We agree with the Tax Court that regardless of whether the taxpayer is regarded as a unitary business, the statute and regulations do not make mandatory the use of the apportionment method to allocate income. The policy of the statute and regulations is to adopt a method which will 'fairly and accurately . . . reflect the net income of the business done within the state.'"

The Court, therefore, allowed the use of the separate accounting method.

Donald M. Drake Co. v. Department of Revenue, 500 P.2d 1041 (1972), was decided after Oregon's adoption of the Uniform Act. The Court distinguished the Utah case on this statutory change, and allowed the company to file under the apportionment method. The court held that under the Uniform Act, the apportionment method was favored over separate accounting.

Under A.R.S. § 43-135(g), the determining factor is which method more clearly reflects income. Therefore, the use of the separate accounting method is allowable if the Department determines that that method more clearly reflects income from business done within this State. In making this determination though, the Department should consider the nature of the business because Department of Revenue Regulation R15-2-135-8(a) provides that generally "The separate accounting method . . . should not be used to apportion the income of a unitary business."

Sincerely,

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